TELEPANEL SYSTEMS INC

ANNUAL REPORT

1998

78250

PRESIDENT'S MESSAGE

To Our Shareholders:

The revenue results for the year illustrate the expansion of the ESL market and underscore Telepanel's leading role in the ESL industry. The increase in revenues to record levels and the initial installations in Europe reflect the significant progress Telepanel made in the year. The year's highlights included the signing of an agreement with Stop & Shop in February to purchase systems for 33 of its stores. In June we received orders to install another two systems for Big Y Foods. In July we signed an agreement covering 50 stores for A&P, installations for which are in progress. We also received additional orders from Wakefern member retailers for a further five stores. In October, we completed a $3 million convertible debenture financing with The VenGrowth Investment Fund Inc. Telepanel Europe installed five systems, and our European product received approval for use throughout Europe.

In the first quarter of this year we shipped 15 new store systems and we received orders from Fleming for our first installations in Pennsylvania and Kentucky, broadening our geographic coverage in the US. Recently, Canadian Business magazine published its annual list of the top 100 Canadian technology companies, ranking Telepanel sixth based on revenue growth. In June of this year, Telepanel Europe received an order from Intermarche for three systems. The majority of supermarkets in the US using electronic shelf labels now use Telepanel ESL's. Having completed our installations for Stop & Shop, we have picked up the pace and have installed our system in 19 stores for A&P to date. A&P continues to aggressively install our system in its other stores. Recently, A&P opened a new showcase store in Danbury, Connecticut with our system installed. We are continuing with a substantial sales effort to expand on our market lead during 1998.

For the fourth quarter ended January 31, 1998, revenues increased 357% to $3,292,876 from last year's fourth quarter. The loss for the quarter ended January 31, 1998 was $3,796,057, ($.21 per share), compared to a loss of $1,606,212 ($.09 per share) in last year's fourth quarter. The primary reason for the increase in the loss was a non-cash expense of $2,047,387 for additional amortization of debenture discount and $320,911 of merger combination and other financing costs. Before these non-recurring charges, the loss for the quarter declined 11% to $1,427,759 or $.08 per share.

For the year ended January 31, 1998, product sales were $9,577,246, an increase of $6,720,821 (235%) over last years' product sales. A non-recurring charge for merger combination and other financing costs of $1,884,607 and a non-cash expense for additional amortization of debenture discount of $2,047,387 were the main reasons for the increase in the loss for the year.

Telepanel leads the ESL industry with a customer base of over 2 million display modules at premier supermarkets and warehouse chains in North America. We are pleased to continue to be endorsed by our marketing partners, IBM Corporation and Fleming Companies, Inc., as the premier vendor of electronic shelf labels.

In October 1997 we entered into an agreement to merge with Electronic Retailing Systems International, Inc. The merger was a learning experience of value for Telepanel that I believe outweighed the time and expense associated with the merger. The Telepanel Board, our shareholders, and I are pleased that we did not complete the merger with ERS. ERS' annual and first quarter results support our decision not to move forward. Fortunately, while the merger was pending we continued with our installation of 54 stores during the year, more than any supplier of ESL's in the world, and completed all of our R&D projects, sales initiatives and cost reduction programs. Because of the postponement of financing activities due to the merger, for accounting purposes, the debentures were reclassified as current liabilities and a non-cash expense for additional amortization of debenture discount was recognized. Even with these unusual expense items, Telepanel's loss for the year was one-quarter of its two main competitors'. Our financing activities have resumed and Telepanel continues to lead the ESL industry. Telepanel has approximately 2.5 times the number of systems installed as its nearest competitor, and it has the highest revenues, the only positive gross margin, the lowest overhead, and the lowest break-even volume in the industry. In addition, 92% of all production wireless ESL's installed in North America are Telepanel's.

In other administrative matters, Telepanel has determined that it is Year 2000 compliant.

The corporate achievements for last year are significant and are in large part due to the hard work of our employees. I would like to take this opportunity to thank Telepanel's customers, suppliers, shareholders and employees, whose efforts and ongoing support are essential to the company's continued success. I understand that the merger placed pressures on our stakeholders and wish to thank them for their support through this difficult time. I look forward to Telepanel's continued leadership of the ESL industry and accelerated sales in both North America and Europe.

Sincerely,

Chris Skillen
President and Chief Executive Officer

AUDITORS' REPORT

To the Shareholders of
Telepanel Systems Inc.

We have audited the consolidated balance sheets of Telepanel Systems Inc. as at January 31, 1998 and 1997 and the consolidated statements of operations and deficit and changes in financial position for each of the years in the three-year period ended January 31, 1998. These financial statements are the responsibility of the company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the company as at January 31, 1998 and 1997 and the results of its operations and the changes in its financial position for each of the years in the three-year period ended January 31, 1998 in accordance with generally accepted accounting principles in Canada.

Price Waterhouse

Chartered Accountants
Toronto, Canada
March 20, 1998
(except for Note 18 which is as at April 22, 1998)

COMMENTS BY AUDITORS' FOR U.S. READERS ON CANADA-U.S. REPORTING DIFFERENCES

In the United States, reporting standards for auditors require the addition of an explanatory paragraph (following the opinion paragraph) when the financial statements are affected by conditions and events that cast substantial doubt on the company's ability to continue as a going concern, such as those described in Note 1 to the financial statements. Our report to the shareholders dated March 20, 1998 (except for Note 18 which is as at April 22, 1998) is expressed in accordance with Canadian reporting standards which do not permit a reference to such events and conditions in the auditors' report when these are adequately disclosed in the financial statements.

Price Waterhouse

Chartered Accountants
Toronto, Canada
March 20, 1998
(except for Note 18 which is as at April 22, 1998)

CONSOLIDATED BALANCE SHEETS

(in Canadian dollars)

	January 31 1998	January 31 1997
Assets		
Current assets		
Cash and cash equivalents	$ 2,277,297	$ 3,943,817
Accounts receivable *(Note 3)*	2,695,535	473,228
Inventories *(Note 4)*	3,334,846	2,373,915
Prepaid expenses	180,653	13,306
	8,488,331	6,804,266
Investment in Telepanel Europe S.A. *(Note 5)*	436,887	277,568
Capital assets *(Note 6)*	524,364	601,149
	$ 9,449,582	$ 7,682,983
Liabilities		
Current liabilities		
Bank and other indebtedness *(Note 7)*	$ 1,065,412	$ 1,430,000
Accounts payable and accrued liabilities *(Note 8)*	3,953,255	769,415
Deposits on sales contracts	1,787,682	–
Debentures *(Note 9)*	6,000,000	–
	12,806,349	2,199,415
Debentures *(Note 9)*	–	2,094,864
Shareholders' Equity *(Deficiency)*		
Capital stock and warrants *(Note 10)*	32,094,339	30,905,776
Other Equity *(Note 9)*	1,474,603	–
Deficit	(36,925,709)	(27,517,072)
	(3,356,767)	3,388,704
	$ 9,449,582	$ 7,682,983

Commitments *(Notes 5 and 18)*

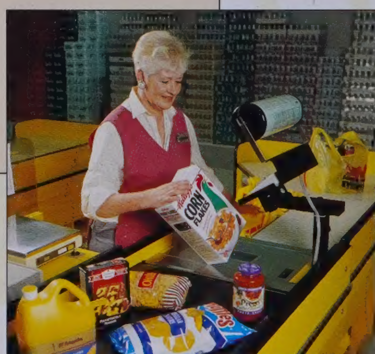
See accompanying notes to financial statements.

Approved by the Board

Director

Director

Pricing accuracy is one of the keys to customer satisfaction, confidence and store loyalty.



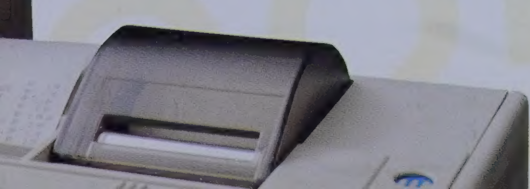
With Telepanel, prices at the shelf edge and the checkout are identical.

CONSOLIDATED STATEMENTS OF OPERATIONS AND DEFICIT

(in Canadian dollars)

	Year ended January 31		
	1998	**1997**	**1996**
Product sales	$ 9,577,246	$ 2,856,425	$ 2,947,086
Expenses			
Manufacturing	6,790,874	2,304,886	3,885,093
Selling, general and administration	5,429,733	3,116,776	2,237,692
Research and development	920,677	499,034	438,456
Amortization of debenture discount *(Note 9)*	553,837	381,111	238,194
Depreciation of capital assets	133,467	151,713	149,426
Amortization of deferred marketing expense	–	152,728	90,390
Debenture interest	462,359	338,745	213,786
Other interest	112,814	67,425	97,942
	14,403,761	7,012,418	7,350,979
Loss from operations before the undernoted items	(4,826,515)	(4,155,993)	(4,403,893)
Interest and other income	234,219	183,527	272,189
Merger combination and financing costs expensed	(1,884,607)	–	–
Additional amortization of debenture discount *(Note 9)*	(2,047,387)	–	–
Equity loss in Telepanel Europe S.A. net of a dilution gain in 1998 of $170,200 *(Note 5)*	(433,777)	(390,153)	–
	(4,131,552)	(206,626)	272,189
Loss for the year	(8,958,067)	(4,362,619)	(4,131,704)
Issuance of shares with respect to exercise of options *(Note 10)*	(450,570)	–	–
Deficit, beginning of year	(27,517,072)	(23,154,453)	(19,022,749)
Deficit, end of year	$ (36,925,709)	$ (27,517,072)	$ (23,154,453)
Loss per common share *(Note 11)*	$ (0.50)	$ (0.25)	$ (0.26)

See accompanying notes to financial statements.

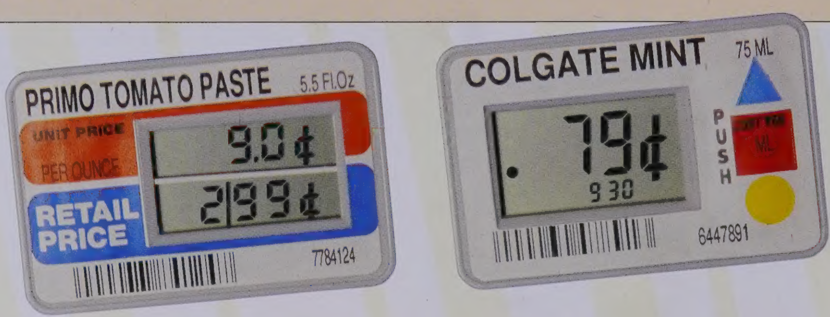


CONSOLIDATED STATEMENTS OF CHANGES IN FINANCIAL POSITION

(in Canadian dollars)

	Year ended January 31		
	1998	1997	1996
Cash provided by (used in)			
Operating activities			
Loss for the year	$ (8,958,067)	$ (4,362,619)	$ (4,131,704)
Items not requiring a current outlay of cash			
Depreciation and amortization	2,734,691	685,552	478,010
Equity loss in Telepanel Europe S.A.	603,977	390,153	–
Dilution gain on equity investment in Telepanel Europe S.A.	(170,200)	–	–
Changes in noncash working capital *(Note 12)*	1,620,937	(421,131)	446,149
	(4,168,662)	(3,708,045)	(3,207,545)
Financing activities			
Issuance of common shares and warrants	737,993	2,488,110	4,792,186
Bank and other indebtedness	(364,588)	730,000	(855,524)
Issuance of debentures	2,778,515	–	1,475,559
	3,151,920	3,218,110	5,412,221
Investing activities			
Equity investment in Telepanel Europe S.A.	(593,096)	(667,721)	–
Purchase of capital assets, net	(56,682)	(44,996)	(288,571)
	(649,778)	(712,717)	(288,571)
Increase (decrease) in cash during the year	(1,666,520)	(1,202,652)	1,916,105
Cash and cash equivalents, beginning of year	3,943,817	5,146,469	3,230,364
Cash and cash equivalents, end of year	$ 2,277,297	$ 3,943,817	$ 5,146,469
Supplemental information			
Interest paid	$ 507,068	$ 377,480	$ 311,728

See accompanying notes to financial statements.



Display modules shown at actual size

Telepanel's wireless electronic shelf labels are the most reliable and cost effective available.

1. Nature of operations and financial condition

Telepanel Systems Inc. (the "company") is a developer, manufacturer and supplier of an electronic shelf pricing and information system for use in the retail industry and, in particular, the supermarket industry. The system enables supermarkets to change product pricing at the shelf by the use of a central computer and radio frequency communications technology. The company's sales are in Canada and principally in the north eastern and central United States.

These consolidated financial statements have been prepared on the basis of accounting principles applicable to a going concern, which assumes that the company will continue in operation for the foreseeable future and will be able to realize its assets and discharge its obligations in the normal course of operations.

The application of the going-concern concept is dependent upon the company receiving the continued support of its lenders and other creditors, its ability to comply with existing bank operating loan and debenture convenants (certain of which the company is currently not in compliance with), its ability to secure additional financing and its ability to generate future positive cash flow. The company is pursuing additional capital resources. Management believes the going-concern assumption to be appropriate; if the going-concern assumption were not appropriate for these consolidated financial statements then adjustments would be necessary in the carrying values of assets and liabilities, reported revenues and expenses and in balance sheet classifications used.

2. General and summary of significant accounting policies

The consolidated financial statements of the company have been prepared in accordance with accounting policies generally accepted in Canada, which, except as described in Note 17, conform in all material respects to accounting policies generally accepted in the United States. The principal accounting policies followed by the company, which have been consistently applied, are summarized as follows:

Use of estimates
The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Basis of financial statement presentation
The financial statements of the company's wholly-owned subsidiary, Telepanel Products Inc., are consolidated. All significant intercompany balances and transactions have been eliminated upon consolidation. Telepanel Europe S.A., an entity not controlled by the company but over which it has the ability to exercise significant influence, is accounted for using the equity method.

Cash and cash equivalents
The company considers all highly liquid debt investments purchased with a maturity of three months or less to be cash equivalents.

Inventories
Inventories are valued at the lower of cost (determined using the first-in, first-out method) and net realizable value. The cost of work in progress and finished goods includes the cost of raw materials, direct labour and related overhead expenses.

Capital assets
Capital assets are recorded at cost. Depreciation is calculated on a declining-balance basis over the estimated useful lives of the assets at the following annual rates:

Computer equipment	30%
Furniture and equipment	20%

Maintenance and repair costs are expensed as incurred.

Revenue recognition
Revenue from the sale of products is recognized at the time the company has completed its contractual commitment with respect to a particular sale.

Financial instruments
Financial instruments are initially recorded at historical cost. If subsequent circumstances indicate that a decline in the fair value of a financial asset is other than temporary, the financial asset is written down to its fair value. Fair value estimates are made at a specific point in time, based on relevant market information and information about the respective financial instrument. These estimates are subjective in nature and involve uncertainties and matters of significant judgement and therefore cannot be determined with precision. Changes in assumptions could significantly affect the estimates. Unless otherwise indicated, the fair values of financial instruments approximate their recorded amounts.

The estimated fair values of the company's cash and cash equivalents, accounts receivable, bank and other indebtedness, accounts payable and accrued liabilities and deposits on sales contracts approximate their carrying values because of their relatively short-term maturities. The fair value of the company's debentures is estimated using discounted cash flow analysis, based on the company's current incremental rates for similar types of borrowing arrangements.

Translation of foreign currencies
The company's foreign subsidiary, Telepanel Products Inc., is classified as integrated. Current assets (excluding inventories) and current liabilities are translated at the rates in effect at the balance sheet date, whereas other assets and other liabilities are translated at rates prevailing at the respective transaction dates. Revenues and expenses are translated at average rates prevailing during the year, except for cost of inventory used and depreciation, which are translated at exchange rates prevailing when the related assets were manufactured or acquired. Currency gains and losses are reflected in operations for the year.

Stock options
Stock options are recorded using the intrinsic value method.

3 Accounts receivable

Included in accounts receivable at January 31, 1998 is a receivable from Telepanel Europe S.A. of $151,882 (1997 — $62,416).

4 Inventories

	1998	1997
Raw materials	$ 1,327,184	$ 437,018
Work in progress	365,966	181,404
Finished goods	1,532,712	1,528,858
Deposits on purchases	108,984	226,635
	$ 3,334,846	$ 2,373,915

5 Investment in Telepanel Europe S.A.

During September 1996, the company, in conjunction with other investors, formed Telepanel Europe S.A. ("Telepanel Europe") to market its products. The company owns a 42% (1997 — 49%) equity interest in Telepanel Europe which is accounted for using the equity method. The company has the right to purchase the other investors' equity in Telepanel Europe, and the other investors have the right to require the company to purchase their equity in Telepanel Europe after June 30, 1998 and before December 31, 2006, subject to profitability requirements for the company and Telepanel Europe, for either cash or shares of the company. The purchase price would be determined according to the earnings per share of Telepanel Europe and the price-earnings ratio of the company's shares. The shareholders have committed to investing up to an additional $3.5 million in Telepanel Europe, of which the company's commitment at January 31, 1998 approximates $1.2 million. Upon completion of these additional investment commitments the company's equity ownership would approximate 35%.

6 Capital assets

	1998			1997		
	Cost	*Accumulated depreciation*	*Net*	*Cost*	*Accumulated depreciation*	*Net*
Computer equipment	$ 319,078	$ 244,674	$ 74,404	$ 275,245	$ 222,179	$ 53,066
Furniture and equipment						
Manufacturing	1,127,371	686,928	440,443	1,117,477	578,054	539,423
Office	46,624	37,107	9,517	43,668	35,008	8,660
	$ 1,493,073	$ 968,709	$ 524,364	$ 1,436,390	$ 835,241	$ 601,149

7 Bank and other indebtedness

The company has a $500,000 (1997 — $1,000,000) bank operating loan bearing interest at prime plus 1¾%, which is secured by a general security agreement. There are certain covenants, including financial ratios, which must be complied with. As at January 31, 1998, the company was not in compliance with certain of the covenants. The balance drawn on this line at January 31, 1998 was $600,000 (1997 — $750,000).

The weighted average interest rate on bank and other indebtedness for the three fiscal years ended January 31, 1998 is 8.06% (1997 — 7.98%; 1996 — 11.07%).

8 Accounts payable and accrued liabilities

	1998	1997
Accounts payable	$ 505,686	$ 265,682
Marketing accrual	1,039,185	88,196
Accrued merger combination and financing costs	1,767,610	–
Accrued payroll costs	33,792	201,463
Other accruals	606,982	214,074
	$ 3,953,255	$ 769,415

9 Debentures and unamortized financing costs and debt discount

On June 15, 1995, the company issued a $3,000,000 debenture repayable at any time before June 15, 1999, bearing interest at 11.26% per year. The debenture is secured by a fixed and floating charge on all assets of the company subordinate to security for bank indebtedness. The company simultaneously issued to the debenture holder 1,200,000 warrants exercisable at $2.50 per share expiring June 15, 2000. The total consideration received for the debenture and the warrants amounted to $3,000,000.

There are certain covenants, including financial ratios, which must be complied with at each fiscal year-end. At January 31, 1998, the company was not in compliance with certain of these covenants. The company is required to make annual principal payments 90 days after the annual fiscal year-end based on a definition of available net cash. No annual payment is required in 1998.

The carrying value assigned to the debenture and the warrants was $1,475,559 and $1,373,875, respectively. The cost of issuing the debenture was $150,566. These costs and the discount related to the warrants were initially amortized over the four-year term of the debenture.

On October 6, 1997, the company issued a $3,000,000 convertible debenture repayable with a penalty at any time before October 6, 2000, bearing interest at 10% per year. The debenture is initially convertible at anytime, at $1 below the ten-day weighted average trading price prior to conversion. The conversion price changes every three months and in no circumstances will the conversion price be less than $2.50 or greater than $4.50 per share. The company can, in general terms, force conversion of the debenture in multiples of $1,000,000 if the weighted share price is above $4.50. There are certain convenants, including financial ratios, that must be complied with at each fiscal year-end. At January 31, 1998, the company was not in compliance with certain of these covenants. The carrying value assigned to the debenture and the conversion thereof was $1,525,397 and $1,474,603, respectively. The cost of issuing the debenture was $221,485. These costs and the conversion value assigned to the debenture were initially amortized over the three-year term of the debenture.

For the year ended January 31, 1998, debenture amortization was $553,837 (1997 – $381,111; 1996 – $238,194). Since the company is not in compliance with certain of the covenants with respect to the debentures, the debentures are callable by the holders. Accordingly, the carrying amount of the debentures have been stated at the principal amount due, the debentures have been classified as current liabilities in the consolidated balance sheet and additional debt discount of $2,047,387 has been recorded in the consolidated statement of operations.

The carrying value of the debentures comprise:

	1998	1997
11.26% debenture		
Principal amount of debenture payable	$ 3,000,000	$ 3,000,000
Less: Unamortized financing costs and debt discount	–	905,136
	3,000,000	2,094,864
10% debenture		
Principal amount of debenture payable	3,000,000	–
	$ 6,000,000	$ 2,094,864

10 Capital stock and warrants

Authorized and issued share capital

On December 5, 1997, the company filed articles of amendment authorizing the company to issue, in addition to the existing authorized unlimited number of common shares, an unlimited number of preference shares, issuable in series. The number of preference shares to be issued and the rights, privileges, restrictions and conditions attached to these shares shall be determined by the directors prior to issuance. The issued common shares and common share warrants are as follows:

	Year ended January 31					
	1998		1997		1996	
	Shares	*Amount*	*Shares*	*Amount*	*Shares*	*Amount*
Capital stock						
Balance, beginning of year	17,630,524	$ 29,480,652	16,557,113	$ 26,992,542	14,967,781	$ 23,569,902
Shares issued for cash						
Issue of shares net of costs (1997 – $15,390)	–	–	1,000,000	2,334,610	1,238,593	2,778,752
Issue of shares on exercise of warrants and options	133,000	316,900	–	–	214,210	322,161
Shares issued for stock appreciation rights ("SAR")	131,133	450,570	–	–	–	–
Shares issued under compensation plans	153,816	421,093	62,047	128,600	136,529	321,727
Shares issued for services and acquisition of capital assets	–	–	11,364	24,900	–	–
Balance, end of year	18,048,473	30,669,215	17,630,524	29,480,652	16,557,113	26,992,542
Warrants						
Balance, beginning of year		1,425,124		1,425,124		55,578
Warrants issued as part of debenture financing, net of costs of $4,329 *(Note 9)*		–		–		1,369,546
Balance, end of year		1,425,124		1,425,124		1,425,124
Total capital stock and warrants		$ 32,094,339		$ 30,905,776		$ 28,417,666

The number of warrants exercisable and changes in the warrants are as follows:

	Number of warrants to purchase shares at $2.50 per share	*Number of warrants to purchase shares at $3.65 per share*	*Total warrants*	*Exercise amount*
Balance, January 31, 1995	–	40,000	40,000	$ 146,000
Issued	1,200,000	–	1,200,000	3,000,000
Balance, January 31, 1998 1997 and 1996	1,200,000	40,000	1,240,000	$ 3,146,000

The warrants to purchase shares at $2.50 and $3.65 per share expire on June 15, 2000 and August 28, 1999, respectively.

The company has an incentive plan under which options to purchase common shares may be granted to its directors, officers and employees at the discretion of the Board of Directors. These options may be exercised as SARs at the option of the participants. Each option under the incentive plan, which allows for the purchase of one share, expires not later than 10 years from the date on which it was granted; however, all options granted to date have been for a three to five-year term. The option exercise price is set at the market value at the grant date.

The number of shares issuable under options and the average option price per share are as follows:

	Shares issuable under options			Weighted Average price per share		
	1998	1997	1996	1998	1997	1996
Shares issuable under options, beginning of year	3,045,500	1,767,500	1,295,210	$ 2.96	$ 3.53	$ 4.08
Granted	125,000	1,333,000	840,000	3.05	2.18	–
Exercised as SARs	(502,250)	–	–	2.55	–	2.38
Exercised for cash	(133,000)	–	(214,210)	2.38	-	1.50
Expired	(146,500)	(55,000)	(153,500)	3.06	2.12	4.67
Shares issuable under options, end of year	2,388,750	3,045,500	1,767,500	$ 3.08	$ 2.96	$ 3.53
Options exercisable at end of year	1,750,437	2,072,625	1,359,750			

During the year ended January 31, 1998, the participants elected to surrender to the company options to purchase 502,250 shares and received from the company 133,133 shares for an aggregate consideration of $450,570.

The options outstanding as at January 31, 1998 to purchase common shares are as follows:

	Options outstanding			Options exercisable	
Range of exercise prices	*Number outstanding*	*Weighted-average remaining contractual life*	*Weighted-average exercisable price*	*Number exercisable*	*Weighted-average exercisable price*
$ 1.70 to $ 2.80	1,918,250	2.4 years	$ 2.31	1,292,437	$ 2.35
$ 2.81 to $ 4.20	176,000	.2 years	4.20	176,000	4.20
$ 4.21 to $ 8.35	294,500	1.2 years	7.47	282,000	7.60
	2,388,750			1,750,437	

11 Loss per common share

Loss per common share is based on the weighted average number of shares outstanding during 1998, 1997 and 1996 of 17,825,619, 17,138,214 and 15,972,660 shares, respectively. The loss per common share from operations before the undernoted items for the three fiscal years ended January 31 is $0.27, $0.24 and $0.28 for 1998, 1997 and 1996, respectively.

12 Consolidated statement of changes in financial position

Changes in noncash operating working capital are as follows:

	1998	1997	1996
Decrease (increase) in current assets			
Accounts receivable	$ (2,222,307)	$ 61,601	$ 57,548
Inventories	(960,931)	(278,934)	133,714
Prepaid expenses	(167,347)	9,981	140,156
Increase (decrease) in current liabilities			
Accounts payable and accrued liabilities	3,183,840	(213,779)	114,731
Deposits on sales contracts	1,787,682	–	–
	$ 1,620,937	$ (421,131)	$ 446,149

13 Strategic alliances and product sales

Telepanel Products Inc. has a cooperative hardware marketing agreement with International Business Machine Corporation ("IBM") to July 1, 1998 whereby IBM acts as nonexclusive representative for the marketing of the company's products in the United States for a fee based on certain of the company's product sales.

During the year ended January 31, 1997, the company granted an exclusive licence to Telepanel Europe to market its products in Europe, the Middle East and Africa. The company has also committed to supply Telepanel Europe with its products at full cost.

Export sales to the United States (which are primarily made in U.S. dollars) for the fiscal years ended January 31, 1998, 1997 and 1996 amounted to $8,665,599, $2,277,354 and $1,903,739, respectively. Sales to Telepanel Europe for the years ended January 31, 1998 and 1997 were $567,458 and $125,667, respectively. The remainder of the company's product sales are in Canada.

The percentage of product sales by individual customer, which account for more than 10% of revenue, are as follows:

	Percentage by customer	
	First customer	*Second customer*
Year ended January 31		
1998	44.90%	15.36%
1997	13.38	N/A
1996	56.90	35.40

14 Fair value of financial instruments

The following table summarizes the carrying amount and estimated fair values of the company's financial instruments:

	January 31, 1998		January 31, 1997	
	Carrying amount	*Estimated fair value*	*Carrying amount*	*Estimated fair value*
Cash and cash equivalents	$2,277,297	$2,277,297	$3,943,817	$3,943,817
Accounts receivable	2,695,535	2,695,535	473,228	473,228
Bank and other indebtedness	1,065,412	1,065,412	1,430,000	1,430,000
Deposits on sales contracts	1,787,682	1,787,682	–	–
Debentures	6,000,000	5,974,000	2,094,864	3,161,000

15 Income taxes

As at January 31, 1998, the company has losses available to be carried forward for income tax purposes amounting to approximately $17,632,000, which can be applied against future taxable income. These losses expire as follows:

1999	$ 347,000
2000	676,000
2001	2,524,000
2002	2,556,000
2003	3,517,000
2004	2,942,000
2005	5,070,000
	$ 17,632,000

As at January 31, 1998, the company has unclaimed research and development expenditures amounting to approximately $6,921,000, which can be applied to reduce future taxable income and are not subject to expiry.

The tax benefit of the losses carried forward and unclaimed research and development expenditures have not been recorded in the consolidated financial statements.

A reconciliation of the income tax recovery at the combined federal and provincial taxation rate to the provision for income taxes is set out below:

	Year ended January 31		
	1998	1997	1996
Loss for the year	$ (8,958,067)	$ (4,362,619)	$ (4,131,704)
Combined federal and provincial taxation rate	44.6%	44.6%	44.6%
Income tax recovery at combined federal and provincial taxation rate	(3,995,000)	(1,946,000)	(1,843,000)
Manufacturing and processing rate reduction	212,000	105,000	116,000
Effect of subsidiary company loss at lower tax rate	10,000	38,000	61,000
Nondeductibility of equity loss and expenses	1,253,000	347,000	106,000
Tax benefit of loss not recorded	2,520,000	1,456,000	1,560,000
Provision for income taxes	$ –	$ –	$ –

16 Rental expense

Rental expense for the years ended January 31, 1998, 1997 and 1996 are approximately $110,000, $106,000 and $97,000, respectively.

17 Reconciliation to United States generally accepted accounting principles

Reconciliation of loss determined in accordance with generally accepted accounting principles in Canada ("Canadian GAAP") to loss determined under accounting principles which are generally accepted in the United States ("US GAAP") is as follows:

	1998	1997	1996
Loss for the year, as reported	$ (8,958,067)	$ (4,362,619)	$ (4,131,704)
Amortization of deferred marketing expense (1)	–	152,728	90,390
Compensation cost for options (2)	(971,149)	–	–
Loss for the year in accordance with United States accounting principles	$ (9,929,216)	$ (4,209,891)	$ (4,041,314)
Basic and fully diluted loss per share in accordance with United States accounting principles	$ (0.56)	$ (0.25)	$ (0.25)

(1) Under US GAAP, the deferred marketing expense would be expensed in the year incurred.

(2) Under Canadian GAAP, the company accounts for the cost of options exercised as SARs as a charge to deficit. Under US GAAP, the compensation costs for options with related SARs is accrued over the vesting period based on the difference between the quoted market value at the grant date and the exercise price and adjusted for changes in the quoted market value of the stock in subsequent periods.

In 1997, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 128, "Earnings per Share". This statement establishes new standards for computing and presenting earnings per share. The company retroactively applied this new standard for its year ended January 31, 1998. There was no effect on prior years of applying this new standard.

On October 6, 1997, the company issued a convertible debenture as described in Note 9. Under Canadian GAAP, the proceeds have been allocated between the debenture and other equity based on the fair value of its conversion feature. Under US GAAP, the proceeds would be allocated between the debenture and other equity based on the intrinsic value of the conversion feature. Accordingly, under US GAAP, the debenture would be recorded at $2,096,386 and other equity at $903,614. Canadian GAAP requires that the resulting discount on the debenture be amortized over the term of the debenture whereas US GAAP requires the amount to be amortized over the period to the earliest exercise date. This would have increased the amortization of the debenture discount under US GAAP by $730,887 for the year ended January 31, 1998 before the expensing of the additional amortization of the debenture discount *(Note 9)*.

On October 7, 1993, the shareholders approved a resolution to reduce the deficit and capital stock of the company by $9,052,137. US GAAP do not allow such a reduction in capital stock. Accordingly, capital stock and deficit of the company would be $9,052,137 greater under United States accounting principles for each of the years presented.

Statement of Financial Accounting Standards No. 109, "Accounting for Income Taxes" ("FAS 109"), requires the liability method under which temporary differences are tax effected at current rates, whereas under Canadian GAAP, timing differences are tax effected at the rates in effect when they arise.

The deferred tax asset consists of:

	1998	1997	1996
Net operating loss carryforwards	$ 7,350,412	$ 5,658,400	$ 4,776,708
Unclaimed research and development costs	2,858,280	2,618,770	2,467,380
Investment tax credits	1,054,219	1,031,084	979,409
Other	337,836	410,538	344,294
	11,600,747	9,718,792	8,567,791
Less: Valuation allowance	(11,600,747)	(9,718,792)	(8,567,791)
	$ –	$ –	$ –

United States GAAP requires the consolidated statements of changes in financial position to reflect financing and investing activities on a cash basis.

Accordingly, the operating, financing and investing activities in the consolidated statements of changes in financial position in accordance with United States GAAP are as follows:

	1998	1997	1996
Cash provided by (used in)			
Operating activities			
Loss for the year	$(9,929,216)	$(4,209,891)	$(4,041,314)
Items not requiring a current outlay of cash			
Common shares and warrants issued for services	421,093	153,500	321,727
Compensation cost for options	971,149	–	–
Depreciation and amortization	2,734,691	532,824	387,620
Equity loss in Telepanel Europe	603,977	390,153	–
Dilution gain on equity investment in Telepanel Europe	(170,200)	–	–
Changes in noncash working capital	1,620,937	(421,131)	446,149
	(3,747,569)	(3,554,545)	(2,885,818)
Financing activities			
Issuance of common shares and warrants	316,900	2,334,610	4,470,459
Bank and other indebtedness	(364,588)	730,000	(855,524)
Debentures *(Note 9)*	2,778,515	–	1,475,559
	2,730,827	3,064,610	5,090,494
Investing activities			
Equity investment in Telepanel Europe	(593,096)	(667,721)	–
Purchase of capital assets, net	(56,682)	(44,996)	(288,571)
	(649,778)	(712,717)	(288,571)
Increase (decrease) in cash during the year	$ (1,666,520)	$ (1,202,652)	$ 1,916,105

In June 1997, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 131, "Disclosures about Segments of an Enterprise and Related Information". This statement establishes standards for the way that public business enterprises report information about operating segments in financial statements and for related disclosures about products and services, geographic areas and major customers. The statement is effective for financial years beginning after December 15, 1997. The company has not yet determined the effect of this statement on its financial statements.

18 Business combination and subsequent event

On October 29, 1997 the company and Electronic Retailing Systems International, Inc. ("ERS") entered into a combination agreement (the "Agreement"). On February 3, 1998 the company signed a joint distribution agreement which provided inter alia for licence and distribution representation and working capital advances (the "Advances") of up to US $2 million which amount was received on February 4, 1998 and is secured by 90% of specified receivables and 50% of specified inventory. The security is second to bank indebtedness and senior to that of the debentures. Interest is payable at the United States prime rate plus 250 basis points.

On April 22, 1998 the company and ERS signed a termination agreement with respect to the Agreement and the joint distribution agreement. This termination agreement requires the company to repay these advances on or before October 5, 1998.

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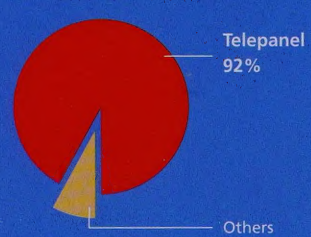

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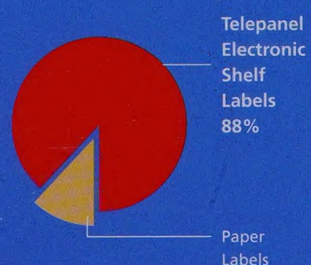

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